No. 11804

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

KENNEDY NAME PLATE COMPANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S OPENING BRIEF.

PRESTON D. OREM,
811 Chapman Building, Los Angeles 14,
Attorney for Petitioner.

Parker & Company, Law Printers, Los Angeles. Phone TR. 5206.

TOPICAL INDEX

PAGE

IV.

V.

VI.

VII.

TABLE OF AUTHORITIES CITED

No. 11804

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

KENNEDY NAME PLATE COMPANY, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S OPENING BRIEF.

Jurisdictional Statement.

This is a petition for a review of a decision of The Tax Court of the United States entered upon July 30, 1947, determining deficiencies in income taxes of petitioner for the taxable years ended June 30, 1941, and June 30, 1942, in the respective amounts of $2,083.19 and $1,413.68; deficiencies in the declared value excess profits taxes of petitioner for the taxable years ended June 30, 1941, and June 30, 1942, in the respective amounts of $1,320.01 and $1,320.00; and deficiencies in excess profits taxes of petitioner for the taxable years ended June 30, 1941, and June 30, 1942 in the respective amounts of $2,023.31 and $4,119.75. [Tr. p. 69.]

The Tax Court of the United States had jurisdiction of the controversy between the parties hereto under the pro-

visions of Section 272 (a) (1) of the Internal Revenue Code.

The petitioner is a California corporation. [Tr. p. 5.]

The pleadings necessary to show the jurisdiction of The Tax Court of the United States are the Petition [Tr. pp. 4-29] and the Answer. [Tr. pp. 29-30.]

The petitioner's corporation income and excess profits tax returns for the fiscal years ended June 30, 1941, and June 30, 1942, were filed with the Collector for the Sixth Collection District at Los Angeles [Tr. p. 34], which is located within the circuit of the United States Court of Appeals for the Ninth Circuit.

The United States Circuit Court of Appeals for the Ninth Circuit has jurisdiction to review the decision of The Tax Court of the United States under the provisions of Section 1141 (b) (1) of the Internal Revenue Code.

The decision of The Tax Court of the United States was entered on July 30, 1947. [Tr. p. 4.] Petitioner filed with the Clerk of The Tax Court of the United States a petition for review by the Circuit Court of Appeals for the Ninth Circuit of the said decision of The Tax Court on October 27, 1947. [Tr. pp. 69-73.] The petition for review, being filed within three months after the entry of the decision of The Tax Court, was timely. (Section 1142 of the Internal Revenue Code.)

Statement of the Case.

The respondent determined certain deficiencies in the income and excess profits taxes of petitioner for the taxable years ended June 30, 1941, and June 30, 1942. [Tr. p. 18.] Petitioner, by appropriate assignments of error, contested the proposed deficiencies, adjustments and holdings of respondent by a petition to The Tax Court of the United States. [Tr. p. 34.]

There were three issues involved in the proceedings before The Tax Court. [Tr. p. 52.] These issues were as follows: (1) As to whether the respondent erred in disallowing as excessive compensation the bonuses which petitioner paid to its two officers during each of the taxable years here involved. (2) As to whether respondent erred in increasing petitioner's income for each of the taxable years by the amount of the proceeds of certain sales of scrap paid over to the two officers in each of the taxable years here involved. (3) As to whether respondent erred in determining that petitioner was subject to the surtax on corporations imposed by Section 102 of the Internal Revenue Code for each of the taxable years here involved. [Tr. p. 52.]

The petitioner was sustained by The Tax Court with respect to the second issue [Tr. p. 32] and the third issue. [Tr. p. 32.]

This petition for review relates to the first issue involving the bonuses paid to the two officers of petitioner which was determined by The Tax Court in favor of respondent. The Tax Court summarizes its opinion on this point as follows:

> "*Held*, petitioner is not entitled to deduct under Section 23 (a) (1) (A), I. R. C., as reasonable compensation for services rendered by its two officers

any amount in excess of the regular salaries paid each year in the total amount of $24,000.00 and proceeds from the scrap sales; *held, further,* the payments of the bonuses were in the nature of dividend distributions on stock and not deductible by petitioner as ordinary and necessary expenses under Section 23 (a) (1) (A)." [Tr. pp. 31-32.]

For the convenience of the Court, there is submitted at this point such findings of fact of The Tax Court as relate to the issue on appeal herein, appearing on pages 34 to 41, inclusive, of the Transcript of the Record:

"Petitioner is a corporation. It was incorporated under the laws of the State of California on August 19, 1923, and has its principal office and place of business in the City of Los Angeles. It filed its corporation income and excess profits tax returns for the fiscal years ended June 30, 1941, and June 30, 1942, with the collector for the sixth collection district at Los Angeles. (21)

"Joseph W. Hayek has been in the name plate business since 1907. From 1907 to 1917 he either managed name plate companies or the name plate departments of various companies. In 1917 he started a name plate business in Minneapolis, Minnesota, under the name of Hayek Nameplate & Novelty Company. In 1921 he sold this business to William James Kennedy and Kennedy's uncle. Kennedy and his uncle moved the business to Los Angeles, California, and began to operate it as a partnership under the name of Kennedy Nameplate Company. Hayek originally became an employee of the partnership and had charge of the production end of the business. Soon thereafter Kennedy's uncle sold his 50 per cent interest in the partnership to Hayek and in 1923

Hayek and Kennedy organized the petitioner herein. The business of the partnership was transferred to petitioner in exchange for the latter's stock. From the time of organization to and through the taxable years here involved Hayek has been the president and a director of petitioner and Kennedy has been the secretary-treasurer and a director. Both men have devoted their entire time to petitioner's business and have engaged in no outside business activities.

"At the time petitioner was organized it issued 1,251 shares of its stock to Hayek, 1,251 shares to Kennedy, and 1 share to a Mr. Frank who became a director along with Hayek and Kennedy. Petitioner had only three directors. Frank was later succeeded by D. R. Koelling who then became the third director. The stock had a par value of $10 per share. During the taxable years here in question the stock that was issued to Hayek was owned by him as his separate property and the stock that was issued to Kennedy was either owned by him as his separate property or by him and his wife, Alice L. Kennedy, as community property. (22)

"Kennedy was employed by various companies in New York City, Chicago, and in South America from 1912 to 1921 when he first engaged in the name plate business. He had had quite extensive experience as an executive and manager and in sales promotion both in the United States and in South America.

"From the time petitioner was organized to and through the taxable years here involved Hayek and Kennedy divided the important managerial functions of petitioner's business between them. Hayek was in complete charge of production, supervising the work of men employed in several different trades

including art, die making, engraving, photography, etching, plating, lithography, decalcomania manufacture and punch press operations. He also employed a portion of the technical personnel. He perfected many new processes and techniques including a new method for camera work, the elimination of certain etching and lithographic operations, die making improvements, new engraving methods, new chemical solutions and new uses for chemical solutions, new processes for plastics and fibre, fluorescent plates and many others. He and Kennedy together devised a new type of conveyor to operate under a bank of infra red light which has been quite successful. Kennedy was in complete charge of all departments and activities of petitioner except production, including sales, advertising, price figuring, employment of a portion of the technical personnel, collections, purchases, finances and also keeping in constant touch with new technological developments and processes.

During the taxable years ended June 30, 1941, and June 30. 1942, Hayek worked from 65 to 75 hours per week as compared with about 45 hours in 1939. Many times he worked on Sunday during the war and more than once he was required to work all night on important war jobs. Kennedy worked about 54 hours per week during the taxable years as compared with about 45 hours per week during 1939 and 1940. (23)

"The business of petitioner during the years 1941 and 1942 included the production of many items in addition to name plates, including scales, dials, instruction and designation plates, luminous, fluorescent and phosphorescent plates and other articles of similar nature which were sold largely to the airplane industry. It was necessary to substitute plastics and

fibres for metals in manufacturing many products because of the shortage of metals and the necessity for conserving strategic materials. The business of the company during these years also involved the use of radium and black light. Many problems arose due to the fumes caused by the use of certain materials, allergies and radioactivity. Government inspection during the war was very rigid, requring greater accuracy in production than in prior years.

"The by-laws of petitioner empowered the board of directors to appoint and remove all officers of the company, prescribe their duties and fix their compensation.

"The minutes of the regular meeting of the board of directors of petitioner held on April 30, 1940, provides in part as follows:

" 'On motion of Jos. W. Hayek, seconded by D. R. Koelling, it was voted to increase the salary of W. J. Kennedy, to $12,000 per year, retroactive to July 1st, 1939. W. J. Kennedy, then relinquished the chair to Jos. W. Hayek, and moved, seconded by D. R. Koelling that the salary of Jos. W. Hayek be increased to $12,000 per year, retroactive to July 1st, 1939.'

"The minutes of the regular meeting of the board of directors of petitioner held on June 11, 1941, provides in part as follows:

" 'On motion of W. J. Kennedy, seconded by D. R. Koelling, a bonus of $5,000 was voted to Jos. W. Hayek and W. J. Kennedy.'

"Petitioner's net sales, officers' compensation (Hayek and Kennedy only), net income before Federal taxes on income, Federal taxes on income, and net profits for the fiscal years ended June 30, 1936, to June 30, 1942, were as follows:

Year ended June 30	Net Sales	Officers' Compensation	Net income before Federal taxes	Federal taxes on Income	Net Profit
1936	82,153.49	6,542.00	16,430.61	2,925.79	13,504.82
1937	98,354.42	15,000.00	13,870.53	2,961.67	10,908.86
1938	109,464.23	15,322.40	6,387.47	1,526.50	4,860.97
1939	109,966.49	15,183.30	10,164.23	1,347.99	8,816.24
1940	151,446.43	24,194.80	15,862.53	2,145.75	13,716.78
1941	256,451.30	34,000.00	46,942.07	16,709.61	30,232.46
1942	363,912.88	34,000.00	91,747.72	50,597.47	41,150.25

"Beginning in 1931 petitioner began paying bonuses to certain of its employees. During the taxable years such bonuses approximated $12,000 to $14,000 per year. During the fiscal years ended June 30, 1937, to June 30, 1942, inclusive, petitioner's employees numbered 39, 36, 37, 53, 73 and 90, respectively.

"Petitioner accumulated certain scrap from time to time which is the metal that was left over from the various jobs. It is usually referred to as 'overs on jobs' and is sold as scrap. The proceeds from the sales of scrap by petitioner amounted to $1,873.16 for the fiscal year ended June 30, 1941, and $1,716.36 for the fiscal year ended June 30, 1942. One-half of these amounts was paid over to Hayek and one-half to Kennedy, who, together with their respective wives, reported the amounts in their individual income tax returns as income from the sale of scrap. Petitioner did not return any of the proceeds from the sales of scrap as income and neither did it deduct any amount as compensation, or otherwise, on account of the said proceeds that were paid over to Hayek and Kennedy. The proceeds from the sale of scrap was a part of petitioner's gross income and should have been returned by petitioner as such. It is

the practice in the name plate industry to permit officers to sell scrap and to regain the proceeds from such sales as a bonus or additional compensation. Everywhere that Hayek ever worked he always got the scrap or part of (25) the scrap. In 1916, when he was working for a Minneapolis concern, his salary was $4,420 plus all the scrap except the scrap from sterling silver. In 1930 he was offered a position at an annual salary of $12,000 plus 20 per cent of the scrap.

"During the years 1941 and 1942 there were only two or three firms besides petitioner in the name plate business in the Los Angeles area. The principal competitor of petitioner in the Los Angeles area was Miller Dial & Nameplate Company. During the years 1941 and 1942 Miller Dial & Nameplate Company was a partnership composed of two brothers, Charles W. Miller and John Dawson Miller. The duties of Charles in the partnership were very similar to those of Kennedy in petitioner and the duties of John in the partnership were very similar to those of Hayek in petitioner. The sales of Miller Dial & Nameplate Company for the calendar year 1941 were approximately $156,000 and for the calendar year 1942 they were approximately $338,000. No salaries were paid to the partners in Miller Dial & Nameplate Company for the year 1941; the partners simply made withdrawals as needed. For the year 1942 the salary of Charles was $24,000 and that of John was $18,000.

"During February or March of the year 1943 the Northern Engraving Company of Racine, Wisconsin, offered to purchase a 51 per cent control of the business of petitioner and to retain the services of Hayek and Kennedy for a period of two years. This offer was rejected.

"Petitioner has declared or paid no dividends, as such, since the fiscal year ended June 30, 1938. (26)"

The foregoing findings of fact, in the opinion of petitioner, present a fair and correct summary of the evidence. To the next to the last paragraph quoted from the findings of fact of The Tax Court, petitioner desires to add the statement that Northern Engraving Company of Racine, Wisconsin, in offering to retain the services of Hayek and Kennedy for two years, offered them $17,000.00 per year each as annual compensation for their services. [Tr. pp. 124-125.]

Pleadings and Proceedings Herein.

PLEADINGS: The petition of petitioner Kennedy Name Plate Company for a redetermination of the deficiencies in income and excess profits taxes for the fiscal years ended June 30, 1941, and June 30, 1942, was filed with The Tax Court of the United States on December 11, 1944. [Tr. p. 2.] The petition alleged errors: (a) In the disallowance as a deduction from net income of a portion of the compensation of J. W. Hayek and W. J. Kennedy for each of the two taxable years in issue. The disallowances included the proceeds of scrap sales and bonuses. (b) In holding that petitioner was availed of for the purpose of preventing the imposition of surtax upon its shareholders by an unreasonable accumulation of earnings, thereby incurring a surtax under the provisions of Section 102 of the Internal Revenue Code for each of the two taxable years in issue. [Tr. pp. 5-6.]

The answer of respondent to the petition, which was filed on February 5, 1945, simply denied the allegations of error. There were no affirmative allegations in the answer. [Tr. pp. 29-30.]

TRIAL: The case was heard before Hon. Eugene Black, Judge, sitting as a circuit division of The Tax Court of the United States, on June 12, 1946, in Los Angeles, California. [Tr. p. 3.]

The Tax Court entered its memorandum Findings of Fact and an Opinion by Judge Black on May 29, 1947. The said court found for the petitioner on the issue involving a proposed surtax under the provisions of Section 102 of the Internal Revenue Code. [Tr. p. 32.] With respect to the compensation issues, the court found for petitioner on the issue involving the proceeds of scrap sales retained by the two officers of petitioner, but found for the respondent on the issue of bonuses paid to the two officers of petitioner. [Tr. pp. 31-32.] Judgment was that decision would be entered later under Rule 50 of The Tax Court. [Tr. p. 65.]

MOTION TO VACATE: On June 20, 1947, petitioner filed a Motion to Vacate and set aside the memorandum findings of fact and opinion on the grounds that The Tax Court had not complied with the provisions of Section 8 of the Administrative Procedure Act (Chapter 324, Public Law 404) in that petitioner had been served with the memorandum findings of fact and opinion without prior notice thereon. and had not been granted a reasonable time to file its objections and exceptions to the proposed findings of fact and opinion prior to their entry by The Tax Court of the United States [Tr. pp. 66-67], said Tax Court being an agency of the Government of the United States within the meaning of Section 2 of the said Administrative Procedure Act.

The Lincoln Electric Co. v. Commissioner of Internal Revenue, 162 F. (2d) 379.

On July 14, 1947, The Tax Court, by Judge Eugene Black, entered an order denying the Motion to Vacate and set aside the memorandum findings of fact and opinion heretofore entered. [Tr. p. 68.]

Decision: On July 30, 1947, The Tax Court entered its decision (under Rule 50) adjudging that there were deficiencies in income and excess profits taxes for the years ended June 30, 1941, and June 30, 1942, as previously stated upon the first page of this opening brief for petitioner. [Tr. pp. 68-69.]

Specification of Errors.

Petitioner specifies the following errors upon which it will rely in the prosecution of this appeal from the judgment of The Tax Court of the United States made and entered upon the 30th day of July, 1947. Petitioner specifies that The Tax Court of the United States erred in each of the following particulars [Tr. pp. 165-166]:

(1) The Tax Court of the United States erred in failing to allow as a deduction under Section 23 (a) (1) (A), Internal Revenue Code, as reasonable compensation for services rendered by its two officers any amount in excess of the regular salaries paid each year in the total amount of $24,000.00 plus proceeds from the scrap sales.

(2) The Tax Court erred in holding that the payments of the bonuses to the two officers in the total amount of $10,000.00 for each year were in the nature of dividend distributions on stock and not deductible by petitioner as

ordinary and necessary expenses under Section 23 (a) (1) (A) of the Internal Revenue Code.

(3) The Tax Court erred in finding that there were deficiencies for the taxable years ended June 30, 1941, and June 30, 1942, in lieu of a determination that there were no income taxes, declared value excess-profits taxes and excess profits taxes due from the petitioner for the two years in controversy.

(4) The Tax Court erred in declining to grant petitioner's motion to vacate and set aside the memorandum, findings of fact, and opinion on the grounds that The Tax Court had not complied with the provisions of the Administrative Procedure Act. (Chapter 324, Public Law 404.)

(5) There was no substantial evidence to justify the findings of The Tax Court within the provisions of the Administrative Procedure Act, and more particularly Section 10 (e) of said Act.

(6) The Tax Court erred in not giving full faith and credit to the resolution of the Board of Directors of petitioner, adopted at the regular meeting of said Board on June 11, 1941, voting bonuses of $5,000 each to the two officers of petitioner.

(7) The Tax Court erred in declining to give proper weight to the testimony of Charles N. Miller with respect to the reasonableness of the compensation paid by petitioner to its two principal officers.

ARGUMENT.

I.

The Tax Court of the United States Erred in Failing to Allow as a Deduction Under Section 23 (a) (1) (A), Internal Revenue Code, as Reasonable Compensation for Services Rendered by Its Two Officers Any Amount in Excess of the Regular Salaries Paid Each Year in the Total Amount of $24,000.00 Plus Proceeds From the Scrap Sales.

Section 23 (a) (1) (A) states as follows, in part:

> "Section 23. In computing net income there shall be allowed as deductions: (a) (1) (A) all the ordinary and necessary expenses paid and incurred in the taxable year in carrying on any trade or business including a reasonable allowance for salaries or other compensation for personal services actually rendered;"

Section 29, 23(a)-6, Regulations of the Commissioner of Internal Revenue, states:

> "(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."

In the *Dobson* case, 320 U. S. 489, the Supreme Court stated:

> "* * * Congress has invested the Tax Court with primary authority for redetermining deficiencies, which constitutes the greater part of tax litigation. This requires it to consider both law and facts. Whatever latitude exists in resolving questions such

> as those of proper accounting, treating a series of transactions as one for tax purposes, or treating apparently separate ones as single in their tax consequences, exists in the Tax Court and not in the regular courts; when the court cannot separate the elements of a decision so as to identify a clear-cut mistake of law, the decision of the Tax Court must stand. In view of the division of functions between the Tax Court and reviewing courts it is of course the duty of the Tax Court to distinguish with clarity between what it finds as fact and what conclusion it reaches on the law. In deciding law questions courts may properly attach weight to the decision of points of law by an administrative body having special competence to deal with the subject matter. The Tax Court is informed by experience and kept current with tax evolution and needs by the volume and variety of its work. While its decisions may not be binding precedents for courts dealing with similar problems, uniform administration would be promoted by conforming to them where possible."

And in *Bingham v. Commissioner,* 325 U. S. 365, the Supreme Court appears to have further extended the finality of the decisions of The Tax Court.

However, the Sixth Circuit Court in *Capitol-Barg Dry Cleaning Co. v. Commissioner,* 131 F. (2d) 712, reversed the Board of Tax Appeals in a case involving the reasonableness of compensation under Section 23 of the Internal Revenue Code. This case was decided before the *Dobson* case, which established the so-called "Dobson rule." However, the Sixth Circuit in its opinion in *Estate of Kroger v. Commissioner,* 145 F. (2d) 901, stated as follows:

> "True it is, as pointed out by appellants, that this Court in *Capitol-Barg Dry Cleaning Co. v. Commis-*

> *sioner of Internal Revenue,* 131 Fed. (2d) 712, held that convincing testimony before the Board of Tax Appeals may not be arbitrarily disregarded. We adhere to the doctrine. The decision of the Tax Court, being deemed 'contrary to the indisputable character of the evidence', was reversed. But the facts of that case bear no remote similarity to those found here."

The Sixth Circuit then goes on to discuss the *Dobson* case. That Court undoubtedly meant to state that its decision in the *Capitol-Barg* case would have been the same even had the *Dobson* case opinion of the Supreme Court been rendered prior to the decision of the Sixth Circuit Court in the *Capitol-Barg* case.

Therefore, it can be said that there can exist a case involving the reasonableness of salary issue upon which The Tax Court could be reversed by a Circuit Court. Anyone reading the statement of facts as given in the findings of fact of The Tax Court would, petitioner believes, arrive at the conclusion that the officers of petitioner, Hayek and Kennedy, were very reasonably compensated for the years 1941 and 1942, as compared with prior years. The net sales of taxpayer showed a great increase, net income before Federal taxes and net profit after Federal taxes showed very large increases, petitioner officers worked much longer hours in 1941 and 1942 than theretofore, and their business was subject to much more rigid inspection. [Tr. p. 38.]

It is difficult in reading the opinion of The Tax Court to follow the reasoning by which that board found that $12,000 per year plus the scrap sales was all that could

be allowed as reasonable compensation to the officers for the years 1941 and 1942. The Tax Court said:

> "There is no doubt that both Hayek and Kennedy worked long hours during the tax years here involved and were very competent in the line of work in which petitioner was engaged, but only about two months prior to the beginning of the tax years here involved their regular salaries were substantially increased up to $12,000 per annum for each officer. This represented an increase of more than 59% over the preceding year. For the reasons previously given and the fact that no dividends were declared since June 30, 1938, we think that $12,000 a year for each officer plus the scrap sales is all that can reasonably be allowed as deductions under Section 23 (a) (1) (A), *supra,* for the taxable years here in question."

It appears that The Tax Court decision on the reasonableness of these salaries was predicated on the fact that two salary increases came too close together and that no dividends had been declared since June 30, 1938. As a matter of law, petitioner contends that the decision of The Tax Court was improper under Section 23 (a) (1) (A) of the Internal Revenue Code. The said section contains no limit upon the number of salary increases that may be attained during a given period nor does it say anything about dividend declarations.

Taxpayers, of course, have the burden of proving reasonableness of salaries. The taxpayer, in addition to submitting statistical data for earnings, presented the testimony of a disinterested and competent witness, Charles W. Miller, which was uncontradicted, and The Tax Court cannot arbitrarily disregard such evidence. *(Capitol-Barg* case, *supra.)* This case is a very similar one to that of *Capitol-Barg Dry Cleaning Co.*

II.

The Tax Court Erred in Holding That the Payments of the Bonuses to the Two Officers in the Total Amount of $10,000.00 for Each Year Were in the Nature of Dividend Distributions on Stock and Not Deductible by Petitioner as Ordinary and Necessary Expenses Under Section 23 (a) (1) (A) of the Internal Revenue Code.

The minutes of the regular meeting of the board of directors of petitioner held on June 11, 1941, provided in part as follows:

> "On motion of W. J. Kennedy, seconded by D. R. Koelling, a bonus of $5000 was voted to Jos. W. Hayek and W. J. Kennedy." [Tr. p. 38.]

In its opinion The Tax Court, in denying that the foregoing bonuses were in reality dividends in disguise, cited Section 19.23 (a)-6 of Treasury Regulations 103, which gives the following illustration [Tr. p. 55]:

> "* * * An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees. it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock."

It is true that like regulations have been held to be fair interpretations of the Congressional intention. (*H. Levine and Bros., Inc., v. Commissioner,* 101 F. (2d) 391.)

However, petitioner directs the attention of the Court to the fact that Hayek and Kennedy divided equally the responsibilities of the company management as shown in the findings of fact and it is only logical to assume that equal salaries to each man and equal bonuses to each man might well have been paid although neither man owned any stock in petitioner corporation whatever.

The Tax Court in its opinion lays great stress on the fact that petitioner paid no dividends since the fiscal year ending June 30, 1938, and increased the compensation of the officers at two different times. [Tr. p. 56.] Petitioner contends that these facts alone cannot support the decision of The Tax Court unless there is something more in the way of evidence to warrant its conclusions. The record fails to disclose such evidence.

III.

The Tax Court Erred in Finding That There Were Deficiencies for the Taxable Years Ended June 30, 1941, and June 30, 1942, in Lieu of a Determination That There Were No Income Taxes, Declared Value Excess Profits Taxes and Excess Profits Taxes Due From the Petitioner for the Two Years in Controversy.

Had The Tax Court found that the total compensation paid to the two officers of petitioner was reasonable for the years 1941 and 1942, there would have been no deficiency in income tax for the years June 30, 1941, to June 30, 1942. This allegation is simply one that must be supported by the other points of taxpayer on appeal.

IV.

The Tax Court Erred in Declining to Grant Petitioner's Motion to Vacate and Set Aside the Memorandum, Findings of Fact, and Opinion on the Grounds That The Tax Court Had Not Complied With the Provisions of the Administrative Procedure Act. (Chapter 324, Public Law 404.)

The Administrative Procedure Act, which became law on June 11, 1946, was intended to have broad coverage, and such exceptions as it recognizes are in terms of functions rather than agencies as such.

The Administrative Procedure Act is concerned with administrative agencies. Section 2 (a) of the Act defines "agency" to mean:

> "each authority (whether or not within or subject to review by another agency) of the Government of the United States other than Congress, the courts, or the governments of the possessions, Territories, or the District of Columbia."

The Tax Court is accordingly subject to the Act if it is an "agency," but not if it is a "court," as those terms are used in this definition.

The Tax Court's predecessor, The Board of Tax Appeals, was created by the Revenue Act of 1924, as "an independent agency in the executive branch of the Government." The Internal Revenue Code, when enacted, described the board in the same way. (I. R. C., Sec. 1100.)

The Supreme Court in *Old Colony Trust Co. v. Commissioner*, 279 U. S. 716, 725, said:

> "The Board of Tax Appeals is not a court. It is an executive or administrative board, upon the decision of which the parties are given an opportunity to base a petition for review to the courts after the

administrative inquiry of the board has been had and decided."

Section 504 of the Revenue Act of 1942 effected the change of the name of The Board of Tax Appeals to The Tax Court of the United States. The Committee Report (H. R. Rept. No. 2333, 77th Congress, 2d Session, pp. 172, 173), explaining Section 504, says:

> "This section merely changes the names by which the Board of Tax Appeals, its chairman and its members, are known. No change is made in its status. The Board, which will hereinafter be known as The United States Tax Court, is continued as an independent agency in the executive branch of the Government. Thus its status as an executive or administrative board is unchanged. Old Colony Trust Co. v. Commissioner, 279 U. S. 716, 725. The Board and its divisions will continue to have the same jurisdiction, powers, and duties as provided by existing law."

In *Commissioner v. Gooch,* 320 U. S. 418, 420, the Supreme Court pointed out that the Board's change of name to Tax Court had no effect on the jurisdiction, powers and duties of the agency.

Since The Tax Court is an agency rather than a court. it would seem to follow that, like other agencies, it is subject to the Administrative Procedure Act.

Had the name of the Board of Tax Appeals remained unchanged it would seem beyond dispute that the Administrative Procedure Act applied to it. The change of name did not make the tribunal any less an agency or otherwise effect its functions.

The Sixth Circuit Court in *Lincoln Electric Co. v. Commissioner, supra,* stated that the permissible scope of review would be fixed by the Administrative Procedure

Act rather than by the *Dobson* ruling since it found The Tax Court to be an agent subject to the Act. The Appellate Court found it unnecessary on the facts before it, however, "to particularize in what respect our power to review has been enlarged except to say that it doubtless has been broadened, and it will be time enough to consider the precise application of the Act when clear cut questions of fact and law are brought to us for review." In *Dawson v. Commissioner*, 163 F. (2d) 664, decided September 22, 1947, the Sixth Circuit Court reaffirmed what it had said in the *Lincoln Electric* case with respect to the Administrative Procedure Act.

If the Sixth Circuit Court is correct in its conclusion with respect to the Administrative Procedure Act, petitioner's motion to vacate and set aside the memorandum, findings of fact and opinion should have been granted. It is true that petitioner in his brief was given an opportunity to submit proposed findings of fact and conclusions but petitioner was not given an opportunity to submit his objections and exceptions pursuant to Section 8 (b) of the Administrative Procedure Act. Section 8 (b) of the Administrative Procedure Act contains a provision to the effect that prior to each recommended initial decision, the parties shall be afforded reasonable opportunity to submit for the consideration of the officials participating in such decisions "(2) exceptions to the decisions or recommended decisions of subordinate officers or to tentative decisions, and (3) supporting reasons for such exceptions." Petitioner was given no opportunity to submit its exceptions to the proposed decision of The Tax Court, as is provided for by Section 8 (b) of the Administrative Procedure Act. Petitioner's motion to vacate and set aside the memorandum, findings of fact and opinion should have been granted.

V.

There Was No Substantial Evidence to Justify the Findings of The Tax Court Within the Provisions of the Administrative Procedure Act, and More Particularly Section 10 (e) of Said Act.

The scope of review as provided by Section 10 (e) of the Administrative Procedure Act provides:

> "So far as necessary to decision and where presented the reviewing court shall decide all irrelevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of any agency action."

It shall hold unlawful and set aside any agency action

> "(5) unsupported by substantial evidence in any case subject to the requirements of Sections 7 and 8 or otherwise provided in the record of the agency hearing provided by statute."

Said section further provides that

> "in making the foregoing determinations the court shall review the whole record or such portions thereof as may be cited by any party, and due account shall be taken of the rule of prejudicial error."

In discussing the substantial evidence requirement, the report of the House Judiciary Committee stated:

> " 'Substantial evidence' means evidence which on the whole record is clearly substantial, plainly sufficient to support a finding or conclusion under the requirements of section 7(c), and material to the issues. It is exceedingly important. Difficulty has come out by the practice of agencies and courts to rely upon something less—suspicion, surmise, implications, or plainly incredible evidence. Although the

agency must do so in the first instance, under this bill it will be *the duty of the court to determine in the final analysis and in the exercise of their independent judgment* whether on the whole of the proofs brought to their attention the evidence in a given instance is sufficiently substantial to support a finding, conclusion, or other agency action or inaction. In reviewing a case under this fifth category the court must base its judgment upon its own review of the entire record or so much thereof as may be cited by any party." (Emphasis supplied.)

Senate Document No. 248, 79th Congress, 2d Session, p. 270.

Section 10 (e) (5) is a forceful adoption of the opinion that substantial evidence is "more than a mere scintilla." (Supreme Court in *Consolidated Edison Co. v. NLRB,* 305 U. S. 209, 229.) Clearly, under this subsection, the functions of the reviewing court are not limited to a mere search of the record to see if the burden of evidence lacks any iota of reliable evidence. Instead courts will be required to base their judgment on review of the entire record or so much of it as may be cited by any party. Affirmance of agency action that is supported only tenuously by the record is foreclosed.

In the Senate proceedings of March 12, 1946, relating to the Administrative Procedure Act (Senate Document No. 248, 79th Congress, 2d Session), the following explanation of Section 10 (e) of the Administrative Procedure Act was furnished by Senator McCarran, Chairman of the Senate Judiciary Committee:

"Mr. Ferguson: Mr. President, will the Senator yield?

Mr. McCarran: I yield.

Mr. Ferguson: Would the Senator, then, say that the judgment or decision of the agency must be based upon stronger proof than a scintilla of evidence?

Mr. McCarran: Very much stronger.

Mr. Ferguson: The old rule which applied in the courts, particularly on certiorari, was that if there was any evidence to sustain the verdict or judgment, it should be sustained. The courts have many times so held. The Senator would say, would he not, that something more than 'any evidence' is required to sustain such a decision.

Mr. McCarran: The answer is in the affirmative. We say that the evidence must be substantial probative evidence.

Mr. Ferguson: So we are changing the rule which has been applied in the past that any evidence, or a scintilla of evidence, as it is sometimes defined, is sufficient to sustain a verdict or judgment.

Mr. McCarran: We tried as best we could to establish a guide for administrative groups so that they would apply the rule in such a way that there would be substantial probative evidence behind their findings, and so that they could say 'We are not afraid to have our findings reviewed by a court.'

Mr. George: Mr. President, will the Senator yield?

Mr. McCarran: I yield.

Mr. George: The courts have many times held that if there is any evidence to sustain the finding of an administrative board under the statute, the courts have no power to intervene. If this bill should become a law would that rule, as heretofore construed by the courts, remain in effect?

Mr. McCarran: The courts have given various constructions. The courts, in reviewing an order, are governed by the provisions of section 10(e), which states the substantial-evidence rule. In other words, in some instances the courts have held that there must be substantial evidence. We are saying that there must be probative evidence of a substantial nature, and that even though the commission or bureau may take hearsay evidence in its hearings, it must have some probative evidence to sustain its finding.

Mr. George: The point I wish to raise is that some of the acts of Congress, particularly those enacted in recent years, have led the courts to hold—and they so hold—that if there be any evidence to sustain the finding of a board or agency, the court has no power to interfere with it.

Mr. McCarran: I would put it in this way—

Mr. George: Would the enactment of this bill require some substantial or probative evidence to support such a finding?

Mr. McCarran: Yes.

Mr. George: Take the labor relations cases. Senators are familiar with them. The circuit courts have frequently complained against what the Labor Relations Board did, but have said, 'We are powerless to interfere with it.' Would this bill change that rule, if the court were of the opinion that there was no probative evidence?

Mr. McCarran: Yes, it would change that rule.

Mr. George: I am pleased to hear it.

Mr. McCarran: I thank the Senator." (Appendix B—Proceedings in Congress—Administrative Procedure—Commerce Clearing House, Inc. Pages 189-190.)

Even under the *Dobson* rule, The Tax Court's conclusion must have substantial evidence to support it. "Hunches" or "intuition" will not suffice. The Tax Court may not reach a conclusion solely by its intuitive powers."

Estate of Lueders v. Commissioner, ... F. (2d) ....., Oct. 16, 1947 (C. C. A. 3rd).

The Tax Court in this case has used its intuitive powers to determine that when petitioner's board of directors voted a bonus of $5,000 to each of its two principal officers for the years 1941 and 1942, that said board of directors and officers did not intend these amounts to be a bonus but were actually declaring dividends under another guise. The Tax Court bases this premise apparently purely upon the fact that "only about two months prior to the taxable year here involved their regular salaries were substantially increased up to $12,000 for each officer. This represented an increase of 59% over the preceding year. For the reasons previously given and the fact that no dividends as such were declared since June 30, 1938, we think that $12,000 a year for each officer plus the scrap sales is all that can reasonably be allowed as deductions (23 (a) (1) (A), *supra*) for the taxable years here in question."

Clearly The Tax Court bases its decision upon its own intuitive powers and not upon any facts found in the evidence. The evidence all supports the reasonableness of the salaries of the officers, Kennedy and Hayek, for the years 1941 and 1942.

VI.

The Tax Court Erred in Not Giving Full Faith and Credit to the Resolution of the Board of Directors of Petitioner, Adopted at the Regular Meeting of Said Board on June 11, 1941, Voting Bonuses of $5,000 Each to the Two Officers of Petitioner.

The by-laws of petitioner empowered the board of directors to appoint and remove all officers of the company, prescribe their duties and fix their compensation. [Tr. p. 38.]

The minutes of the regular meeting of the board of directors of petitioner held on June 11, 1941, provide in part as follows:

> "On motion of W. J. Kennedy, seconded by D. R. Koelling, a bonus of $5,000 was voted to W. J. Kennedy and Jos. W. Hayek." [Tr. p. 38.]

The Treasury Regulation covering bonuses reads as follows:

> "Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for services actually rendered by employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compen-

sation for services, are not deductible from gross income." (Sec. 29.23 (a)-8, Reg. 111.)

There is nothing in the record to support a statement that the bonuses paid by petitioner to its officers were not made in good faith and as additional compensation for services actually rendered. In *Capitol-Barg Dry Cleaning Company v. Commissioner of Internal Revenue, supra,* the Court said as follows:

> "The facts, apart from opinion evidence, are uncontroverted and as indicated in the memorandum opinion of the board were fully accepted by it. But the board did not give full faith and credit to the resolution of November 30, 1936, by which the claimed allowances were authorized. This resolution created the inference that the salary allowances were reasonable. Toledo Grain & Milling Co. v. Commissioner, 62 Fed. (2d) 171; Ox Fibre Brush Co. v. Blair, 32 Fed. (2d) 42."

The Tax Court failed to give full weight and credit to the actions of the directors in voting the bonuses to officers of petitioner.

VII.

The Tax Court Erred in Declining to Give Proper Weight to the Testimony of Charles W. Miller With Respect to the Reasonableness of the Compensation Paid by Petitioner to Its Two Principal Officers.

In discussing the testimony of Charles W. Miller, The Tax Court said in its statements of fact [Tr. pp. 40-41]:

> "During the years 1941 and 1942 there were only two or three firms besides petitioner in the name plate business in the Los Angeles area. The principal competitor of petitioner in the Los Angeles area was Miller Dial & Nameplate Company. During the years 1941 and 1942 Miller Dial & Nameplate Company was a partnership composed of two brothers, Charles W. Miller and John Dawson Miller. The duties of Charles in the partnership were very similar to those of Hayek in petitioner. The sales of Miller Dial & Nameplate Company for the calendar year 1941 were approximately $156,000 and for the calendar year 1942 they were approximately $338,000. No salaries were paid to the partners in Miller Dial & Nameplate Company for the year 1941; the partners simply made withdrawals as needed. For the year 1942 the salary of Charles was $24,000 and that of John was $18,000."

In commenting upon the testimony of Charles W. Miller, The Tax Court said:

> "Petitioner in its briefs contends that considerable weight should be given to the testimony of Charles W. Miller, one of the partners of Miller Dial & Nameplate Company. The latter company was the principal competitor of petitioner in the Los Angeles area. During 1942, this competitor paid its two part-

ners total salaries of $42,000. Miller's testimony can not be given the weight for which petitioner contends for the reason that during the years 1941 and 1942 Miller Dial & Nameplate Company was a partnership and not a corporation. As a partnership it could easily distribute all of its earnings in the form of salaries to its partners without being questioned by the taxing authorities. That is not true in the case of corporations where consideration must be given to whether the payments are in fact purely for services actually rendered and whether they were reasonable under all the circumstances. *Cf.* Woodcliff Silk Mills, 1 B. T. A. 715." [Tr. pp. 57-58.]

The Tax Court declined to admit the testimony of Carlisle John Thorson, a corporation adviser, generally familiar with salaries of industrial corporations, but not having a knowledge and familiarity with the nameplate business. [Tr. pp. 152 and 153.] The Tax Court having limited petitioner with respect to expert testimony on the question of salaries to the testimony of persons in the nameplate business, petitioner was naturally very limited in presenting expert testimony for the reason that there was only one nameplate company of comparable size in the Los Angeles area. For this reason petitioner avers that great weight should be given to the testimony of Charles W. Miller. The Tax Court appears to have given little weight to his testimony for the reason that his firm was a partnership and not a corporation. Surely this would not disqualify Mr. Miller as to his knowledge as to what might constitute a reasonable salary to an officer of

a nameplate company. Mr. Miller testified that $20,000 per year would be a reasonable salary for the services of Mr. Kennedy and $20,000 would be a reasonable salary for the services of Mr. Hayek for the year ended June 30, 1941. [Tr. pp. 139-140.] He testified that $25,000 each would be a reasonable salary for the two men for the year ended June 30, 1942. [Tr. p. 141.]

In *Capitol-Barg Dry Cleaning Co. v. Commissioner, supra,* the Court said in discussing the testimony of expert witnesses:

> "Their competency was not questioned. Their integrity was not attacked. They were not discredited in any manner known to the law and no color, bias, prejudice or self-interest appears in their testimony. Their testimony was unimpeached and should have been accepted by the Board in a matter in which the Board itself had no knowledge or experience upon which it could exercise an independent judgment. Where the testimony before the Board ought to have been convincing it may not arbitrarily be disregarded."

The experts referred to were the President and Treasurer of the largest retail dry cleaning concern in Cincinnati and the Executive Secretary of the Ohio State Association of Dyers and Cleaners. These witnesses were familiar with the business of the Capitol-Barg Dry Cleaning Co. in a general way and with the industry in general. The same might be said of petitioner's witness, Charles W. Miller.

RELIEF SOUGHT.

The decision of The Tax Court should be reversed as not in accordance with the law or as unsupported by the evidence, or, in the alternative, the decision should be reversed and the case remanded to The Tax Court of the United States for such other and necessary procedure under the Administrative Procedure Act as the case may require.

Respectfully submitted,

PRESTON D. OREM,
Attorney for Petitioner.